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PERUVIAN FOREIGN EXCHANGES 1929–1950*

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THIS THESIS is a study of the vicissitudes of the Peruvian sol between 1929 and 1950. Based upon this experience, certain broad criteria for a future foreign exchange policy are laid down.

Foreign trade plays a very important role in the Peruvian economy. Exports consist of a few raw materials, subject to great price fluctuations. Imports, consisting of a large variety of manufactured and semimanufactured goods, as well as of some basic foods such as wheat, do not, in the aggregate, fluctuate in price as much as exports. Peru is an atomistic buyer and seller in world markets. Therefore, she practically has no influence on the foreign exchange prices of her imports and exports, and cannot affect her terms of trade by conscious policy. Peru's foreign exchange market is far from competitive. Though there are large numbers of buyers of exchange, most of the supplies are controlled by a relatively small number of firms.

Between 1929 and 1950, the sol depreciated considerably. It declined from 2.50 soles to the dollar in 1929 to about 15.00 soles to the dollar in 1950. There can be no doubt that the immediate and primary cause of this depreciation is found in the rise in the supply of payment media, which increased from 153 million soles at the end of 1929 to 2592 million soles by the end of 1950. This rise in the quantity of money was almost wholly the result of domestic factors, especially of government deficits. Foreign exchange inflows were a relatively insignificant cause.

The Peruvian economy was drastically affected by the World Depression. Between 1930 and 1932 inclusive, foreign exchange supplies declined by at least 76 per cent. Exchange controls were not established. Rather, the country adjusted to this decline by depreciation, income deflation, and the suspension of service on the government foreign debt. Depreciation was found preferable to a stable exchange rate under a gold standard as a means of adjusting to falling exchange supplies. During the one depression year during which

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Peru was on the gold standard, real incomes declined by considerably more for a given fall in real imports than was the case during those years during which the sol depreciated. This was caused by the inadequate downward flexibility of the Peruvian cost price structure.

Following 1932, the value of exports, the supplies of exchange, and the Peruvian economy recovered. Fiscal deficits also stimulated the economy. The exchange rate improved. Then, durnig 1938 and 1939, the value of exports declined, and the sol depreciated considerably. This depreciation protected Peruvian producers from the depressing effects of falling world prices. It also tended to shift the distribution of expenditures in favor of domestically produced goods. At the same time, the demand for goods and services was stimulated by heavy fiscal deficits. As a result of these deficits and the sol's depreciation, domestic output increased to such an extent that Peru weathered the world recession of 1938 without suffering a decline in her real national product.

During World War II, the sol was stabilized with the aid of a voluntary control mechanism. However, during the war years, the supply of money increased so much, and, notwithstanding price controls, prices increased to such an extent, that, as the war approached its end, the sol was considerably overhauled. This domestic inflation was caused by domestic deficits. Full-fledged exchange controls were established at the beginning of 1945 to maintain the exchange rate and channel the country's exchange supplies into desirable uses. However, the exchange control machanism proved highly inefficient. Interested parties were unable to agree upon quotas for the allocation of exchange. Furthermore, the domestic inflation, produced by government deficits and commercial bank credit expansion, continued unabated. The sol became still more overvalued. Exporters, in a precarious economic condition because of rising domestic costs, began to resist controls in 1948. At the end of that year, controls began to be gradually abandoned and the sol was allowed to find its own level.

At the present, the sol is a currency whose fluctuations are limited only by Central Bank intervention in the market. There are no exchange controls. However, exporters have to give a certain proportion of their foreign exchange earnings, a proportion decided by administrative action, to the Central Bank. In return, they receive foreign exchange certificates which have to be sold within a specified period of time for whatever the market will pay. The exchange these certificates represent can be used for imports only or for other au-

thorized purposes. This foreign exchange certificate system tends to minimize speculation and further the use of the country's foreign exchange earnings for imports and other purposes considered desirable.

A fluctuating exchange rate best serves Peru's interests. A stable rate would not be desirable. The Central Bank should generally let the exchange rate vary in such a way as to offset foreign price level movements. Thereby, maximum price stability will be furthered in Peru. This is desirable from the point of view of optimum resource allocation. Such rate fluctuations will also minimize the depressive effects of falling world prices upon Peruvian output and income. In order to maximize this output, the sol should not be allowed to appreciate before a reasonably full level of employment has been reached.

If, for any reason, the Central Bank's foreign exchange holdings should be insufficient to maintain a rate based on these criteria, the sol must depreciate. However, such depreciation, which generally would have to exceed that warranted by movements of prices abroad, need and should not be uniform. It should discriminate between the most and the least desirable imports. Such discrimination is recommended because of the country's extremely uneven distribution of income. However, this discrimination should be only temporary, and should therefore not be used in order to depress the demand for foreign exchange in the event of a structural maladjustment caused by other than temporary phenomena. Here, general, non-discriminatory depreciation produces sectional price movements which tend to help in the allocation of the resources affected by the structural difficulty.